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News Release

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THE EFFECTS OF ENERGY PRICE CHANGES ON COMMODITY PRICES, INTER-PROVINCIAL TRADE, AND EMPLOYMENT

TORONTO, Oct. 19, 1976.... Ontario's best policy is to try to ensure that petroleum and natural gas prices remain uniform throughout Canada, since any two-way price system between eastern and western Canada would be tantamount to a provincial tariff, according to a research study released today by the Ontario Economic Council.

"The Effects of Energy Price Changes on Commodity Prices, Inter-provincial Trade, and Employment" by James R. Melvin of the Department of Economics, University of Western Ontario, says that such "provincial tariffs" seek to improve the welfare of the petroleum-producing provinces by allowing them to take advantage of their monopoly trade position. "They are attempting to use an export tariff to improve their terms of trade, that is, to impose an optimum tariff".

Two obvious effects of such a policy, says Melvin, are: (1) a transfer of income from non-petroleum-producing provinces to Alberta and (2) an automatic increase in production costs in provinces in which fuel prices are higher. Such increases inevitably affect both commodity prices and employment in non-producing provinces, such as Ontario, the study points out.



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While finding that commodity prices are less influenced than one would expect by large increases in prices of petroleum, coal and natural gas, the study shows that effects on unemployment might be significant. Melvin discusses various policy options, such as subsidies or retaliatory measures, through which Ontario might counter such effects.

While subsidies could offset commodity price increases, they would be very expensive and difficult to administer, says the author. Retaliatory measures, such as a change in the Ontario Corporate Income Tax, would not, in his opinion, be appropriate.

A calculation of commodity price changes resulting from an assumed 100 per cent increase in petroleum product prices found that such changes were relatively small. With such an increase across Canada, prices in the agricultural and food product sectors would rise more in Ontario, and those in the manufacturing sector, less. This suggests that the terms of trade would turn in Ontario's favour if energy price increases were uniform throughout Canada. (Bill C-32, recently introduced into the House of Commons by the federal government, essentially provides that the prices of natural gas and petroleum, exclusive of transportation and service costs, be uniform throughout Canada.)

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Other points made by the study are:

- An overall increase in the price of petroleum will have a larger effect on commodity prices in Canada than in the U.S. Reasons: (1) as a colder country, Canada requires more coal and petroleum to heat factories and offices and (2) because of the abundance of hydrocarbon fuel, Canadians may not economize on these products. The first reason is not correctable, although the second may be. Uniform price increases for petroleum products in North America would favour U.S. industry. This suggests that there may be an economic justification for maintaining a price differential between Canada and the U.S.
- If Canada adopts world prices for petroleum, as prices continue to rise she will find herself more and more at a price disadvantage relative to the U.S. However, the overall price effects are not large, and evidence suggests that a 100 per cent increase in petroleum price in both Canada and the U.S. would be about equivalent to a 1 per cent increase in the Canadian exchange rate.
- Any industrial shifts generated by the petroleum crisis are likely to be because of either real or imagined shortages, and not because of possible commodity price effects generated by petroleum price increase.
- Attempts by provincial governments to capture a larger share of the Canadian GNP through the imposition of trade restrictions are likely to result in a lower level of welfare for everyone.

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Melvin points out that, while provinces have no authority to impose tariffs, they can impose "a system of domestic taxes that can bring about the same kind of distortion between domestic and foreign prices as is brought about by tariffs." This is a particular concern when, as in the case of petroleum, the product in question is used not only as a final consumer product (for cars and heating) but also for the production of other commodities, the study states.

In Canada, the BNA Act specifically prohibits provinces from imposing taxes at the production level, allowing them only at the retail level. "But essentially the same results can be obtained if private companies decide to charge higher prices for their products," Melvin says. "From a terms-of-trade viewpoint, it makes no difference whether the provincial government or the oil companies raise the price."

While basing his findings on input-output models, the accuracy of which may be questioned "in the long run", Melvin concludes that

(1) by far the best policy for Ontario to pursue is to attempt to make sure that any petroleum and natural gas price increases are applied equally to all industries in Canada, and that a domestic two-price system not be instituted.

(2) even relatively large increases in the price of petroleum and natural gas lead to rather modest commodity price increases, even when the indirect effects are taken into account.

The Ontario Economic Council, established in 1962 as an independent advisor to government, undertakes research and policy studies to encourage the optimum development of the human and material resources of Ontario and to support the advancement of all sectors of the province.

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(Selected quotes attached.)

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Selected Quotes: James R. Melvin, Ontario Economic Council Study: "The Effects of Energy Price Changes on Commodity Prices, Interprovincial Trade, and Employment"

"In discussing the possibility of a two-price system within Canada, the implicit assumption has been that uniform price increases throughout Canada will be neutral interregionally... however, it has been found that on account of differences in interindustry structures, the commodity price effects of a uniform increase in petroleum prices will differ across Canada. Similar differences are found between Canada and the U.S." (Pg.6)

"There will be a terms-of-trade effect any time the price of petroleum, or of any other major commodity, is changed. Government decree, company price-policy changes, corporation tax changes, or even property tax changes can all change the terms of trade and result in an international redistribution of income. Who benefits from this terms-of-trade improvement will depend crucially on how the change is generated". (Pg. 16)

"With employment and output in Ontario increased, a uniform increase in the price of petroleum would be expected to be beneficial to Ontario relative to the rest of Canada. From Ontario's point of view, policies which stabilize prices across Canada at higher levels thus represent, not a neutral policy, but an expansionary one". (Pg. 77)

"....we are supposing that Canadian petroleum prices will be kept lower than in the rest of the world. Moreover, our discussion takes no account of what is to be done with the tax revenue, which we have assumed has been collected and which has caused this increase in petroleum prices. Which level of government gets this revenue and how it is spent are clearly going to make a significant difference with regard to the total effect on output and employment." (Pg. 77)

"While some retaliation through increases in the provincial corporate income tax is possible, any increase large enough to bring about an extensive price change is likely to have serious consequences with regard to the location of industry. It seems almost certain that major changes in the Ontario income tax relative to other provinces would prompt many firms to leave Ontario for other parts of Canada". (Pg. 86)

THE EFFECTS OF ENERGY PRICE CHANGES ON COMMODITY PRICES, INTERPROVINCIAL TRADE, AND EMPLOYMENT

- A research study commissioned by the Ontario Economic Council.

ABOUT THE AUTHOR:

JAMES R. MELVIN is a professor of economics at the University of Western Ontario, London, Ont. A native of Manitoba, he received his B.Sc. from the University of Manitoba, his M.A. from the University of Alberta, and his Ph.D. from the University of Minnesota. He has contributed to a number of academic and economic journals, and is currently engaged in research in international trade and urban economics.